China and the Renminbi

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On August 11th 2015, China surprised us with a change in the RMB fixing mechanism (RMB fix, by which it manages the exchange rate against the US dollar) to a market based methodology. The RMB fix is announced daily and the RMB spot rate is permitted to trade up to 2% above or below it. Previously the mechanism was officially given as being a weighted-average price offered by market makers, but the market believes it is the PBOC that has set the price.

The PBOC (China's Central Bank) has now asked market makers to base their contribution to RMB fixing on:

a. The previous day's closing exchange rate (FX rate)
b. RMB supply and demand conditions
c. Market movements in other major currencies.

The effect has been to move the China Yuan Renminbi (CNY) fix from RMB 6.1162 to the dollar (1.52% above the market-driven spot rate) to RMB 6.2298, in line with the spot rate and a fall of 1.86%.

The immediate reaction in the foreign exchange market was similar declines of 1.86% in the onshore RMB spot rate and 2.75% in the offshore RMB spot market as traders seek to work out what the PBOC's new currency policy is telling us.

Our quick view

First, an explanation

The Renminbi exchange rate against the dollar has weakened as a direct result of Central bank policy, and in that regard it is correct to say this is a depreciation. However, currency depreciation is often viewed in the context of foreign competition, exports and domestic economic weakness.

The position here is not so straightforward.

1. China is in the process of internationalizing its currency. A major part of this is its current drive to have the RMB included in the basket of currencies that make up the IMF's Special Drawing Rights (SDRs) alongside the US dollar, euro, pounds sterling and Japanese yen. The IMF's five-yearly review is taking place this year; they have signalled to China that the currency needs to be usable, convertible and marketable. The previous mechanism, which was both opaque and produced a rate well away from the market spot rate, stood out as running counter to those aims. It is significant that IMF officials have recently concluded a series of meetings in China.
2. In its statement about the strength of RMB's real effective exchange rate (REER), the PBOC asks the market to take account of currency movements of China's trading partners, most of which have weakened against the RMB, and of China's increased cost structure. But the drop itself is not large enough to have a big impact on exports, and seems designed to fend off criticism from trading partners that any currency weakness is unjustified. If the aim was to seek adjustment on REER basis (and we don't believe so), it has not worked, as many emerging market currencies also weakened.

3. The move from an administered currency pricing mechanism (albeit resulting in a drop) fits with China's deregulation of interest rates, increasing interest rate competition, opening up of the capital account, establishment of more overseas RMB clearing centres and growing outbound investment. This lends credibility to the PBOC's position that this is a one-off adjustment for a specific purpose.

Now, the uncertainty

This move came without warning, which is in keeping with the PBOC's approach to their foreign exchange policy. While understandable, we and the market are not yet sure what will happen next, and the PBOC's stance over the next few days and weeks will need to be watched. Here are some scenarios:

1. The RMB daily fixing follows (a) the prior day's closing spot price.

   This would likely result in a steadily depreciating currency, which in turn could cause capital outflows to pick up and currency weakness to accelerate. We consider this outcome undesirable from the PBOC's perspective, and unlikely.

2. The PBOC allows the daily fix to follow (a) the prior day's closing spot price, but stands ready to intervene to curb volatility and provide an indication of its desired rate.

   China may already have been intervening in the spot market, and in the short term this may imply a need for greater intervention before backing off.

3. The daily fix does not become more flexible and greater attention is paid to (b) supply and demand conditions and (c) market movements of other major currencies.

   In this case, the setting of the daily fix will remain opaque, and greater uncertainty will have been introduced leading to higher currency volatility.

4. We do not yet know the degree to which the RMB will be permitted to drift lower against the dollar, or the balance that will be struck between stability and support for exports.

Impact of the change

The Renminbi

The currency has weakened against the dollar and could weaken further, but we believe this will be modest. We stick to our view that this move should be seen as a structural change in foreign exchange management and should be seen in the context of structural changes already underway in lending and deposit rates, in interbank markets, in onshore bond markets and in capital account opening.

Offshore RMB bonds

There has been muted impact so far, with some selling from Asian private banks (which tend to be faster money), but buyers appeared as bond prices fell by 0.25 to 0.375 points. The possibility of a weaker RMB over the longer term may result in higher inflation expectations. There has been a small steepening at the 7–10 year end of the sovereign yield curve. For the present, bond market activity suggests concurrence with the view that the move is a change to the mechanism rather than a change in policy.

Equities

China and Hong Kong stock markets didn't move much on the news. There was greater impact in stock markets elsewhere in Asia Pacific, where currencies fell between 0.5% and 1.3% on the day. The evolution of China's currency regime is as yet uncertain and markets await more information before taking a view.

--Edmund Harriss

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Mutual Fund investing involves risk. Principal loss is possible. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater of emerging markets countries. Investments in derivatives involve risks different from, and in certain cases, greater than the risks presented by traditional investments. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility. Non-diversified funds concentrate assets in fewer holdings than diversified funds. Therefore, non-diversified funds are more exposed to individual stock volatility than diversified funds. Investments in debt securities typically decrease in value when interest rates rise, which can be greater for longer-term debt securities. Investments focused in a single geographic region may be exposed to greater risk than investments diversified among various geographies.

Exchange rate (FX Rate) is the rate at which one currency will be exchanged for another.

The currency abbreviation for the China yuan renminbi is (CNY), the general term for the currency of the People's Republic of China (PRC).

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